No. 92-1074

FILED
JUL 9 1993
OFFICE OF THE CLERK

IN THE
# Supreme Court of the United States
OCTOBER TERM, 1992

---

JOHN HANCOCK MUTUAL LIFE
INSURANCE COMPANY,
*Petitioner,*

v.

HARRIS TRUST AND SAVINGS BANK,
AS TRUSTEE OF THE SPERRY MASTER
RETIREMENT TRUST NO. 2,
*Respondent.*

---

ON WRIT OF CERTIORARI TO THE
[illegible] COURT OF APPEALS
[illegible] SECOND CIRCUIT

---

[illegible] CURIAE OF
[illegible] OF RETIRED PERSONS,
[illegible] AND THE
[illegible] LAWYERS ASSOCIATION
[illegible] RESPONDENT

---

[illegible]

[illegible] Inside Cover]

BEST AVAILABLE COPY

EDGAR PAUK
LEGAL SERVICES FOR
THE ELDERLY
130 West 42nd Street
Suite [illegible]
New York, NY [illegible]
(212) [illegible]
Counsel for Amicus
Legal Services for the Elderly

JEFFREY LEWIS
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]

## TABLE OF CONTENTS

## TABLE OF AUTHORITIES

### CASES

## STATUTES AND REGULATIONS







## MISCELLANEOUS

No. 92-1074

IN THE
**Supreme Court of the United States**
OCTOBER TERM, 1992

JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY,
*Petitioner*,

v.

HARRIS TRUST AND SAVINGS BANK, AS TRUSTEE OF THE SPERRY MASTER RETIREMENT TRUST NO. 2,
*Respondent*.

**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT**

**BRIEF *AMICI CURIAE* OF AMERICAN ASSOCIATION OF RETIRED PERSONS AND LEGAL SERVICES FOR THE ELDERLY IN SUPPORT OF RESPONDENT**

## INTEREST OF *AMICI CURIAE*

The American Association of Retired Persons (AARP) is a nonprofit membership organization of more than 33 million persons age 50 or older, dedicated to addressing the needs and interests of older Americans. AARP seeks through education, advocacy and service to enhance the quality of life for all by promoting independence, dignity and purpose. One of AARP's primary goals is to promote the economic security

of individuals as they age, by increasing the availability, security, equity, and adequacy of public and private pension plans.

Legal Services for the Elderly (LSE) was founded in 1968 to provide free legal services to the elderly poor. At varying times, it has served as a national back-up center to all legal services offices in the country, as the United States Administration on Aging back-up center to their funded offices in New York and New Jersey, and continually as the only litigational back-up center in the State of New York.

It is presently funded by the federal Legal Services Corporation to provide legal advice and litigation support to all legal services attorneys in New York City in several areas of the law of concern to the elderly, including the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001 et seq. It has on its staff a former member of the Department of Labor (DOL) ERISA Advisory Council appointed to represent all pensioners.

The National Employment Lawyers Association (NELA), formerly the Plaintiff Employment Lawyers Association, is a voluntary organization, founded in 1985, of over 1,500 attorneys who specialize in representing individuals in controversies arising out of the workplace. It is the country's only professional membership organization comprised of lawyers who represent individual employees in cases involving employment discrimination, employee benefits, wrongful discharge, and other employment-related matters.

NELA has devoted itself to supporting remedial legislation and precedent-setting litigation affecting the rights of individuals in the workplace in Congress and in the federal and state courts. NELA has a direct interest in the law governing the construction and application of the Employee Retirement Income Security Act (ERISA) because the clients of NELA members frequently have claims for benefits that this statute governs. NELA is qualified to brief this Court on



the implications of its decision in this case, having participated as *amicus curiae* in numerous other cases involving employment laws, including the leading Supreme Court case on ERISA, Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101 (1989).

Employees and retirees depend on the fiduciary protections that the Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1001 et seq., mandates for private employer-sponsored pension plans. In particular, ERISA's fiduciary protections are of vital concern to the elderly poor since the quality of their lives in retirement depends heavily on the amount of their pensions. The Court of Appeals' decision in this case protects retired and working Americans' interests in the approximately half trillion dollars of pension plan assets held by individuals and pension plans in group annuity contracts.[1] AARP, Legal Services for the Elderly, and NELA have a substantial interest in the resolution of the issue herein, which has a direct and vital bearing on retirement security, and therefore submit this brief *amici curiae*[2] to facilitate a full consideration by the Court of this issue.

## SUMMARY OF ARGUMENT

In the decision below, the Court of Appeals held that the guaranteed benefit policy exclusion under ERISA § 401(b)(2), 29 U.S.C. § 1101(b)(2), does not apply to the non-guaranteed "free funds" portion of a group annuity contract issued to a pension plan. Accordingly, insurance companies are subject to ERISA's fiduciary rules when investing these non-guaranteed "free funds." This decision protects participants and beneficiaries from insurance

---

1 Amicus Brief of American Council of Life Insurance in Support of the Petition for a Writ of Certiorari at 1.

2 The written consents of the parties have been filed contemporaneously with this brief with the Clerk of the Court pursuant to Supreme Court Rule 37.3.

companies' breaches of fiduciary duties. Harris Trust & Savings Bank v. Hancock Mutual Life Insurance Co., 970 F.2d 1138 (2d Cir. 1992).

In contrast to this decision, the Department of Labor (DOL), by its own admission, interprets its regulation explaining the guaranteed benefit policy exclusion in a way that diminishes the protections under ERISA for participants and beneficiaries. *Amicus* Brief of the United States Supporting Petitioner at 17 n.9. The DOL's position is inconsistent both with ERISA's mandate to protect participants and beneficiaries and with previous positions the DOL has taken in its bulletins and regulations. Because of these inconsistencies, the Department of Labor's position is not entitled to deference. Bowen v. Georgetown University Hospital, 488 U.S. 204, 212-213 (1988); United States v. Larionoff, 431 U.S. 864, 873 (1977).

Without protections provided by ERISA's fiduciary duty rules, participants and beneficiaries may lose the benefits of positive investment experience and may lose all protections from insurance companies' breaches of fiduciary duties. The Court of Appeals recognized that positive investment experience from the nonguaranteed portion of the group annuity contract affects the amount of funds available to the plan and the participants. Harris Trust & Savings Bank v. Hancock Mutual Life Insurance Co., 970 F.2d at 1144. Thus, such experience could both enhance and secure participants' retirement benefits. Moreover, if insurance companies do not have to comply with ERISA's fiduciary provisions when investing the non-guaranteed "free funds" portion of a group annuity contract, there may be no protection for participants and beneficiaries from insurance companies' breaches of fiduciary duties because state insurance guaranty associations will not protect them. Clearly, this result would frustrate the intent of ERISA to protect the retirement funds of participants and beneficiaries.



## ARGUMENT

### I. THE DEPARTMENT OF LABOR'S CURRENT INTERPRETATION OF IB 75-2 IS NOT ENTITLED TO DEFERENCE BECAUSE IT IS INCONSISTENT BOTH WITH ERISA'S PURPOSES AND THE DOL'S PREVIOUS INTERPRETATIONS.

For the first time in any litigation concerning non-guaranteed benefits paid from insurance companies' general accounts, the DOL presents a new interpretation of "Interpretive Bulletin Relating to Prohibited Transactions 75-2" (IB 75-2). DOL's new interpretation of IB 75-2 provides that ERISA's general fiduciary rules do not apply to any general account contracts sold by insurance companies which may, at some time in the future, pay fixed annuities because such contracts are not plan assets. The DOL announces that its new position must be given deference for two reasons - - one, it is the agency in charge of interpreting ERISA, and two, its position has remained consistent. *Amicus* Brief of the United States Supporting Petitioner (DOL Brief) at 9-11.

Agency interpretations are entitled to deference only if they are consistent with the statute and if the enforcing agency's position has been consistent over time. Bowen v. Georgetown University Hospital, 488 U.S. at 212-213; United States v. Larionoff, 431 U.S. at 873. See generally Chevron, U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837 (1984). In this case, the DOL's position is neither consistent with Congress' purpose in enacting ERISA, nor has it remained consistent over the years.

### A. The DOL's Position Is Inconsistent With ERISA's Purpose To Protect Participants And Beneficiaries So That Their Retirement Funds Will Be Secure.

This Court has previously recognized that ERISA's principal purpose is to "make sur[e] that if a worker has been promised a defined pension benefit upon retirement - and if he has fulfilled whatever conditions are required to obtain a vested benefit - he actually will receive it." Central States Pension Fund v. Central Transport, Inc., 472 U.S. 559, 569 (1985), quoting Nachman Corp. v. Pension Benefit Guaranty Corp., 446 U.S. 359, 375 (1980). To ensure that employees receive their benefits, Congress passed ERISA to safeguard employees and retirees from the abuse and mismanagement of those funds which are accumulated to pay retirement benefits. Fort Halifax Packing Co. v. Coyne, 482 U.S. 1, 15 (1987); Massachusetts Mutual Life Insurance Co. v. Russell, 473 U.S. 134-153 n. 8 (1985). In ERISA, Congress enacted elaborate provisions for the regulation of pension plans, including fiduciary standards of care for plan fiduciaries. Metropolitan Life Insurance Co. v. Massachusetts, 471 U.S. 724, 732 (1985). Congress declared ERISA's purpose:

> [to] protect . . . participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts.

ERISA § 2, 29 U.S.C. § 1001(b) (emphasis added).

Congress' purpose in enacting ERISA was to protect the retirement security of participants and beneficiaries. The



DOL is charged with carrying out that mandate.[3] However, the DOL admits that its current interpretation of IB 75-2, and its later codification at 29 C.F.R. § 2509.75-2, actually reduces protections for participants and beneficiaries. DOL Brief at 17 n.9. By interpreting its bulletin in such a manner, DOL violates ERISA's mandate.[4] Because DOL breached the statutory mandate, its current interpretation of its bulletin is not entitled to deference. United States v. Larionoff, 431 U.S. at 873.

### B. The DOL's Current Position Is Inconsistent With Its Previous Interpretations That ERISA Covers Insurance Companies' General Accounts.

The DOL's interpretation is also not entitled to deference because its current position is inconsistent with its previous interpretations. In keeping with ERISA's mandate to protect participants and beneficiaries, the DOL initially recognized that insurance companies' general accounts were covered by ERISA's fiduciary duty rules. The DOL's previous pronouncements contradict its new interpretation of the bulletin as presented in its *amicus* brief.

---

[3] ERISA §§ 2, 408, 502(a), 504, & 505, 29 U.S.C. §§ 1001(b), 1108, 1132(a), 1134 & 1135. The Secretary of Labor may take action to enforce ERISA's fiduciary standards, issue prohibited transaction exemptions, conduct investigations, collect civil penalties and prescribe regulations to carry out ERISA's purposes.

[4] The DOL notes that the Second Circuit Court of Appeals' decision provides a more narrow construction of the "guaranteed benefit policy" exclusion. DOL Brief at 12. AARP, LSE, and NELA submit that a narrow construction of the exclusion would better effectuate the broad protections intended by Congress. See generally A.H. Phillips v. Walling, 324 U.S. 490, 493 (1945) ["Any exemption from humanitarian and remedial legislation must therefore be narrowly construed, giving due regard to the plain meaning of the statutory language and the intent of Congress."]

### 1. DOL Interpretive Bulletin 75-2 Relates Only to Prohibited Transactions.

The significance of IB 75-2 -- a lone DOL pronouncement regarding application of ERISA's Prohibited Transaction provisions -- to the issue herein can only be understood by appreciating the interrelationship of ERISA's provisions governing fiduciary responsibilities. ERISA § 406, 29 U.S.C. § 1106, sets forth specific transactions which typically entail a high potential for abuse. Donovan v. Cunningham, 716 F.2d 1455, 1464-65 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984). Each of the transactions listed in ERISA § 406 is an automatic violation of the statute, regardless of the reasonableness or prudence of the transaction, unless the transaction is exempted by statute or by a prohibited transaction exemption under ERISA § 408, 29 U.S.C. § 1108.

A transaction which violates the prohibited transaction rules under ERISA § 406 automatically violates the general fiduciary rules under ERISA § 404, 29 U.S.C. § 1104. Associates in Adolescent Psychiatry, S.C. v. Home Life Insurance Co., 729 F. Supp. 1162, 1184-85 (N.D. Ill. 1989), aff'd, 941 F.2d 561 (7th Cir. 1991), cert. denied, 112 S.Ct. 1182 (1992) (Associates). See, e.g., Leigh v. Engle, 727 F.2d 113, 123 (7th Cir. 1984) (the per se rules make enforcement of the general fiduciary rules much easier); Davidson v. Cook, 567 F. Supp. 225 (E.D. Va. 1983), aff'd, 734 F.2d 10 (4th Cir. 1984); Marshall v. Mercer, 4 Empl. Ben. Cas. [BNA] 1523, 1533 (N.D. Tex. 1983) (self-dealing is also a breach of prudence). Moreover, even when a transaction is exempted from the prohibited transaction rules, it is not exempt from the fiduciary responsibility rules. See Donovan v. Cunningham, 716 F.2d at 1465. The DOL itself recognizes



this principle.[5] However, a transaction which violates the general fiduciary rules under ERISA § 404 does not automatically violate the prohibited transaction rules. Donovan v. Cunningham, 716 F.2d at 1465; Associates, 729 F. Supp. at 1184-85.

It is thus consistent with this framework that certain assets could be considered plan assets for purposes of ERISA § 404's general fiduciary rules, but not for the prohibited transaction rules of ERISA § 406. Rather than a blanket pronouncement on the scope of the general fiduciary duty provisions of ERISA, IB 75-2, by its title and plain language, is confined to interpreting the scope of the Prohibited Transaction provisions of ERISA § 406.

IB 75-2 reads in relevant part:

> (b) Contracts or policies of insurance. If an insurance company issues a contract or policy of insurance to a plan and places the consideration for such contract or policy in its

---

[5] When the DOL issues an individual exemption from the prohibited transaction rules, there is no exemption from the general fiduciary rules. The DOL's typical language is as follows:

> The fact that a transaction is the subject of an exemption granted under section 408(a) of ERISA . . . does not relieve a fiduciary of a plan to which the exemption is applicable from certain other provisions of ERISA, including . . . the general fiduciary responsibility provisions of section 404 of ERISA which, among other things, require a fiduciary to discharge his duties with respect to the plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion in accordance with section 404(a)(1)(B) of ERISA.

See, e.g., Prohibited Transaction Class Exemption 75-1.

> general asset account, the assets in such account shall not be considered to be plan assets. Therefore, a subsequent transaction involving the general asset account between a party in interest and the insurance company, will not solely because the plan has been issued such a contract or policy of insurance be a <u>prohibited transaction</u>.

29 C.F.R. § 2509.75-2(b) (emphasis added) (orig. publ. Feb. 6, 1975, republished without change to paragraph (b) on Nov. 13, 1986, 51 Fed. Reg. 41262, 41280).

If anything, IB 75-2(b) provides certain contracts with a "safe harbor" from ERISA's prohibited transaction provisions, but <u>not</u> from the statute's central fiduciary responsibility provisions. This reading is consistent with the DOL's own interpretation in its Prohibited Transaction Class Exemptions. <u>Id</u>. This point also was well made in <u>Associates</u>, and the Court of Appeals adopted the reasoning of the <u>Associates</u> court in its decision below. <u>Harris Trust & Savings Bank v. Hancock Mutual Life Insurance Co.</u>, 970 F.2d at 1145. In <u>Associates</u>, the court rejected the insurance company's reliance upon IB 75-2(b) as a complete exemption from ERISA:

> It seems perfectly consistent to this Court that plan assets might be considered such for purposes of general fiduciary duties, but not for purposes of the prohibited transactions rules. For example, without the policy stated in the bulletin, independent investment transactions between an insurer and large corporate employers who had purchased the insurer's general account products through a multiemployer plan could be deemed unlawful under § 406 -- even though there would be little, if any, chance that one employer could influence the insurer's



> investment decisions. <u>Nevertheless, it could still be sound statutory policy to subject the insurer to fiduciary duties more generally, while exempting it from the per se conflict-of-interest prohibitions of § 406.</u>

<u>Id.</u> at 1185 (emphasis added; citations omitted).

Moreover, the <u>Associates</u> court's analysis is consistent with the DOL's previous pronouncement on this issue. Discussing the differences between IB 75-2 and its final plan asset regulation, the DOL in 1986 stated that the plan asset regulation was broader because it determined the reach of all of ERISA's fiduciary responsibility requirements, not just the Prohibited Transaction rules. 51 Fed. Reg. 41262 (No. 219) (Nov. 13, 1986).

**2. The "Plan Asset" Regulation.**

The long and tortured history of the "Plan Asset" regulation, 29 C.F.R. § 2510.3-101, further reveals that the DOL believed that ERISA's fiduciary responsibility provisions should apply to insurance company general account assets.[6]

---

[6] <u>See</u> 29 C.F.R. § 2510.3-101 (final Plan Asset regulation discussed in detail and published at 51 Fed. Reg. 41262 (Nov. 13, 1986)). This regulation resulted from an extremely long and complex regulatory process. The DOL's first proposal was made in 1979. 44 Fed. Reg. 50363 (Aug. 28, 1979) (then proposed as 29 C.F.R. § 2550.401b-1). This was followed by a notice and comment period and hearings. 44 Fed. Reg. 61618 (Oct. 26, 1979); 44 Fed. Reg. 74858 (Dec. 18, 1979); 45 Fed. Reg. 7521 (Feb. 1, 1980). Following this period, the DOL offered a new proposal, the "1980 proposal." 45 Fed. Reg. 38084 (June 6, 1980). The 1980 proposal was also followed by a notice and comment period. In May 1982, the DOL published final regulations dealing only with "guaranteed governmental mortgage pool certificates" and exemptions to the requirements that all plan assets be held in trust. 29 C.F.R. § 2550.403b-1; 47 Fed. Reg. 21241 (May 18, 1982). The DOL promised to deal with the other issues raised by

The proposed Plan Asset regulation was more far-reaching than IB 75-2 because it governed not only prohibited transactions, but also the issues of what constitutes a plan asset and who is a fiduciary under ERISA. 51 Fed. Reg. 41262 (Nov. 13, 1986).

Initially proposed by the DOL in August 1979, the Plan Asset regulation was approved finally on November 13, 1986. The regulation would have given the insurance industry substantial relief. Subsection (d) of the proposed regulation stated:

> Notwithstanding the provisions of subsection (a), in the case of a plan which is funded in whole or in part by a contract or policy of insurance issued by an insurer, the assets of the plan shall include the contract or policy under which the benefits are insured but shall not, solely by reasons [sic] of the issuance of such contract or policy, include the assets of the insurer issuing the contract or policy <u>except to the extent that such assets are maintained by the insurer in one or more separate accounts and do not constitute surplus in any such account</u>.[7]

---

its 1980 proposal "in the near future." 47 Fed. Reg. 21241 (May 18, 1982). In January 1985, the DOL officially withdrew the 1979 and 1980 proposals and offered a new proposal. 50 Fed. Reg. 961 (Jan. 8, 1985). A notice and comment period and hearing were held on the 1985 proposal, which was the basis for the final regulation. In April 1986, Congress ordered the DOL to adopt final regulations defining plan assets by December 31, 1986. 29 U.S.C. § 1135(d). On November 13, 1986, the DOL did so. 29 C.F.R. § 2510.3-101 (1986).

[7] 44 Fed. Reg. 50363, 50366 (Aug. 28, 1979) (emphasis added). The original plan asset regulation was proposed as 29 C.F.R. § 2550.401b-1. 44 Fed. Reg. 50363 (Aug. 28, 1979).



The Plan Asset regulation, as finally enacted, does not mention insurance company general accounts or provide a "safe harbor" for such accounts.[8] The DOL in 1985 withdrew the 1979 version of the regulation, and has not promulgated any provision similar to subsection (d).

In early 1985, the DOL received comments from the American Council of Life Insurance (ACLI), a national trade association for the life insurance business, on the DOL's new plan asset proposal. These comments requested that the DOL reinsert an explicit statement that assets held in general accounts pursuant to contracts with ERISA-covered plans are not plan assets and thus managers of such assets are not fiduciaries.[9] The DOL declined to do so. In November 1986, the DOL adopted the final Plan Asset regulation without providing a "safe harbor," or indeed, any "harbor" at all for insurance company general accounts. 29 C.F.R. § 2510.3-101 (1986).

Clearly, the DOL's previous interpretation of IB 75-2 had been that general account assets are not excluded by the guaranteed benefit account exclusion and therefore are covered by the ERISA fiduciary rules. In its *amicus* brief, the DOL takes a position that is completely inconsistent with these previous interpretations. This inconsistency is evident in at least four ways. First, in its request for an extension of time to file an *amicus* brief requested by the Second Circuit in this case, the DOL stated that it "had not formulated a final position on the issue." <u>Harris Trust & Savings Bank v. Hancock Mutual Life Insurance Co.</u>, 970 F.2d at 1140.

---

[8] 29 C.F.R. § 2510.3-101 (1986). The final regulation merely states that IB 75-2(b) is unaffected by the regulation. <u>See also</u> 29 C.F.R. § 2509.75-2 (1986).

[9] Letter of Steven W. Kraus, ACLI Associate General Counsel, to DOL Office of Regulations and Interpretation, Office of Pension and Welfare Benefit Programs, dated March 19, 1985, with enclosure. <u>Amicus</u> App. at 1-17.

Second, when the DOL finally responded to the Second Circuit, it stated that:

> the need to fully consider all of the implications of these issues within the Department precludes our providing the court with a brief within a foreseeable time frame.

Id. at 1141.

Third, IB 75-2, by its title and plain language, only concerns prohibited transactions, and has no bearing on general fiduciary responsibilities, which remains consistent with previous DOL interpretations. Fourth, in its *amicus* brief, the DOL never discusses the plan asset regulation - the regulation which provides guidance on the determination of a plan asset. In the plan asset regulation, the DOL stated that the plan asset regulation was broader than IB 75-2 because it determined the reach of all of ERISA's fiduciary responsibility requirements, not just the Prohibited Transaction rules. 51 Fed. Reg. 41262 (No. 219) (Nov. 13, 1986). Moreover, the history of the plan asset regulation indicates that the DOL rejected an exclusion of insurance company general accounts from ERISA's fiduciary rules and a "safe harbor" for such accounts. See pp. 11-13, supra.

It is only with the *amicus* brief in this case that the DOL takes a new and different position on IB 75-2. Clearly, if the DOL's position concerning the interpretation of this bulletin had remained consistent throughout the past eighteen years, there would have been no reason not to put forth its position sooner. Because of this inconsistency, the DOL's position is not entitled to deference.



## II. PARTICIPANTS AND BENEFICIARIES BENEFIT FROM POSITIVE INVESTMENT EXPERIENCE IN A DEFINED BENEFIT PLAN.

The Court of Appeals found that "investment performance clearly does affect the amount of funds available to the plan and its participants." Harris Trust & Savings Bank v. Hancock Mutual Life Insurance Co., 970 F.2d at 1144. In contrast, the district court reasoned that the fluctuation resulting from Hancock's investment experience was irrelevant to the plan's participants and beneficiaries because "covered employees receive a fixed amount determinable by reference to the terms of the plan and not by investment performance." Harris Trust & Savings v. John Hancock Mutual Life Insurance, 722 F. Supp. 998, 1016 (S.D.N.Y. 1989). Accord, Mack Boring and Parts v. Meeker Sharkey Moffitt, 930 F.2d 267, 272-73 (3d Cir. 1991).

The district court below apparently believed that if an employer has a defined benefit plan,[10] the employees' benefits are fixed and secured (paid either by the employer or the insurer) and the success or failure of the plan's investments is of no significance to the plan's beneficiaries. In essence, this analysis leads to the conclusion that ERISA's fiduciary rules should not apply to defined benefit plans. This conclusion not only lacks any support in the record, but is wrong for two reasons. First, positive investment experience can enhance a retiree's retirement benefits. Second, positive investment experience can secure a retiree's retirement benefits.

---

[10] A defined benefit plan promises a participant a specific amount of pension benefits at retirement determined under a formula based on years of participation in the plan, and in most nonbargained plans, based on an average of compensation. C.I.R. v. Keystone Consolidated Industries, Inc., 113 S. Ct. 2006 (1993). See generally S. Bruce, Pension Claims: Rights and Obligations 17-18 (1988).

### A. Positive Investment Experience Can Enhance Retirement Benefits.

Beneficiaries of defined benefit plans depend upon positive investment experience to enhance their benefits in two ways. Enhancement of benefits can occur through either an increase in the absolute amount of benefits or through ad hoc post-retirement increases.

If a pension plan has obtained positive investment returns over a number of years, the plan trustees can choose to make benefits more generous for all participants and beneficiaries, thus providing more retirement income. Usually benefits are increased by a change in the benefit formula such as increasing the percentage of average compensation used in calculating the benefit amounts.

Enhancement of benefits after retirement is also important to participants and beneficiaries because "inflation can severely erode the purchasing power of a fixed pension throughout a worker's retirement years."[11] S. Allen, R. Clark, & A. McDermed, "Post-Retirement Benefits Increases in the 1980s," Trends in Pensions 1992 319 (U.S. Department of Labor, Pension and Welfare Benefits Administration, 1992) [hereinafter "Trends in Pensions"].

In order for plan trustees to be in a position to enhance benefits, plan assets need to increase. Obviously, plan assets will grow the better investments perform. The

[11] At an annual inflation rate of five percent, the purchasing power of a $5,000 annual pension will decrease to approximately $1,900 in twenty years. S. Wachter, Inflation and Pensions 190, Table 5-6, 261 & 365 (1987). See also "Defined Benefit Pension Plans", Employee Benefits in Medium and Large Firms, 1991, 79, 84 (U.S. Department of Labor, Bureau of Labor Statistics, 1993); "Defined Benefit Pension and Defined Contribution Plans", Employee Benefits in Small Private Establishments, 1990, 69, 72 (U.S. Department of Labor, Bureau of Labor Statistics, 1991).



greater the amount of plan assets, the more likely a plan will grant post-retirement increases to participants and beneficiaries, either through an ad hoc adjustment to the annuity amount or a lump sum payment. Trends in Pensions at 331, Table 13.2; "Defined Benefit Pension Plans," Employee Benefits in Medium and Large Firms, 1991, 79, 84 (U.S. Department of Labor, Bureau of Labor Statistics, 1993).

The likelihood of a post-retirement increase and the generosity of the amount of the increase, if granted, correlate to the plan's funding arrangements and rates of return. A study has shown that plans funded wholly through insurance companies were less likely to grant post-retirement increases than plans funded solely through a trust fund.[12] Trends in Pensions at 325, 328 & 334. Significantly, participants received larger post-retirement increases from better funded plans than from under-funded plans and from plans with higher rates of return than from plans with lower rates of return. Id. at 328.

### B. Positive Investment Experience Can Secure Retirement Benefits.

Beneficiaries of defined benefit plans also depend upon positive investment experience to secure their benefits. For example, the poor performance of an insurance company caused the reduction of benefits to participants and beneficiaries, according to unrebutted evidence in Mack Boring and Parts v. Meeker Sharkey Moffitt, 930 F.2d at 269-70.

Moreover, just because an employee participates in a defined benefit plan, the employee's benefits are not

[12] Most benefit increases were discretionary, or ad hoc, rather than automatic cost of living adjustments. Employee Benefits in Medium and Large Firms, 1991 at 84 & 99, Tables 96 & 97; Employee Benefits in Small Private Establishments, 1990 at 72 & 79, Table 77.

necessarily secure if a plan is terminated. If the Pension Benefit Guaranty Corporation (PBGC) assumes operation of a terminated plan,[13] a participant may lose some or all of his retirement benefits.[14] Even the PBGC guarantee of a reduced benefit may not be secure because government studies suggest that the PBGC may have serious long-term funding shortfalls due to potential liability from underfunded plans. Underfunded plans place participants at risk of losing benefits.

---

[13] An employer may terminate the pension plan by demonstrating that it will enter into bankruptcy if the plan is not terminated or by demonstrating that its pension costs are unreasonably burdensome because of a decline in the number of employees covered by the plan. ERISA § 4041(c)(2)(B), 29 U.S.C. § 1341(c)(2)(B). The PBGC may terminate the plan for four reasons: (1) the plan has not met ERISA's minimum funding standards; (2) the plan is unable to pay benefits when due; (3) the plan has made a distribution of $10,000 or more to a substantial owner; or (4) PBGC will suffer an unreasonable long-run loss if the plan is not terminated. ERISA § 4042, 29 U.S.C. § 1342. The PBGC does not guarantee defined contribution plans. 29 U.S.C. §§ 1301(a)(15) & 1322.

[14] First, the PBGC only guarantees a participant's benefits up to a specified amount. In 1993, the maximum guaranteed amount is $29,250 per year for a participant who retires at age 65. ERISA § 4022(b)(7), 29 U.S.C. § 1322(b)(7); 29 C.F.R. § 2621.3. Second, the PBGC will only guarantee certain benefits and will pay benefits only in certain forms. Examples of benefits which the PBGC will not guarantee are pension benefit increases in effect less than five years before termination, retiree health benefits, death benefits, disability benefits and vacation pay. ERISA §§ 4022(a), 4002(a)(2), & 4001(a)(8), 29 U.S.C. §§ 1322(a), 1302(a), 1301(a)(8); 29 C.F.R. §§ 2613.7(a), 2613.4(a)(2)(i) & (c)(1), & 2613.5(a)(2) & (3). The PBGC will not pay benefits in a lump sum form, even if the plan specifically permits such a benefit option, unless it is under the amount of $3,500. 29 C.F.R. § 2613.7(b)(1). See also Testimony of Joseph F. Delfico, Improving the Financial Condition of the Pension Benefit Guaranty Corporation, (GAO/T-HRD-92-60, Sept. 25, 1992). Third, although nonvested benefits are required to become nonforfeitable, they are nonforfeitable only "to the extent funded." ERISA § 4022(a), 29 U.S.C. 1322(a); I.R.C. § 411(d)(3).



Clearly, improved funding of underfunded pension plans through increased contributions and better investment return is beneficial to participants.[15]

## III. STATE INSURANCE LAWS DO NOT PROTECT RETIREES' BENEFITS.

Without ERISA's protection, retirees would have to rely on state insurance laws. However, retirees may lose benefits when an insurance company becomes insolvent because state guaranty associations do not protect group annuity contracts from insurance companies' breaches of fiduciary duties.

Should a pension plan invest in an insurance company, the insurance company become insolvent and the plan incur losses, such investment losses normally would not be covered by state guaranty associations. Significantly, unallocated funding instruments such as Group Deposit Administration contracts and Immediate Participation Guarantee annuity contracts -- the types of contracts at issue here -- are generally not covered by state guaranty associations.[16] If a defined contribution plan invests in an unallocated funding instrument,

---

[15] PBGC's deficit as of the end of fiscal 1991 was approximately $2.3 billion, and its potential deficit may grow to $17.9 billion by the year 2001 in the worst case scenario. See e.g., Hidden Liabilities Increase Claims Against Government Insurance Program, (GAO/T-HRD-93-0, Dec. 30, 1992); Improving the Financial Condition of the Pension Benefit Guaranty Corporation, (GAO/T-HRD-92-60, Sept. 25, 1992); Financial Condition of the Pension Benefit Guaranty Corporation, (GAO/T-HRD-92-52, Aug. 11, 1992).

[16] Fifteen states and the District of Columbia specifically do not cover unallocated funding instruments; nineteen states specifically cover such instruments; and sixteen states do not specify whether such instruments are covered by the state guaranty associations. Protections for Retirees' Insurance Annuities Can Be Strengthened at 17 (GAO/T-HRD-93-28, Mar. 31, 1993).

the participant directly bears any capital loss; if a defined benefit plan invests in this same instrument, the plan bears the loss. But, as noted by the GAO,

> [o]ne implication of the lack of state guarantee is that maintaining funding levels may put excessive financial pressures on the plan sponsor. This could push some companies towards bankruptcy, increasing plan terminations and thus PBGC's liabilities.

Testimony of Joseph F. Delfico, Insurance Company Failures Threaten Retirement Income at 14 (GAO/T-HRD-91-41, Jun. 27, 1991).

For the group annuity contract at issue in this case, the state guaranty associations generally would not provide protections for any losses. If this contract is also exempt from ERISA's coverage by virtue of the guaranteed benefit policy exclusion, there would be no protection at all, thereby frustrating ERISA's purpose to protect participants and beneficiaries so that their retirement funds will be secure.

Retirees may lose retirement benefits even where the state guaranty associations supposedly provide protections. Three GAO reports document the lack of protection for retirees whose benefits are paid by insurance companies in case of insurance company failures. Testimony of Joseph F. Delfico, Insurance Company Failures Threaten Retirement Income, (GAO/T-HRD-91-41, Jun. 27, 1991); Millions of Workers Lose Federal Benefit Protection at Retirement, (GAO/T-HRD-91-79, Apr. 25, 1991); Protections for Retirees' Insurance Annuities Can Be Strengthened, (GAO/T-HRD-93-28, Mar. 31, 1993) [hereinafter Protections]. Lack of protections include failure to cover retirees if they are not state residents, failure to cover retirees if the insurance company did not meet state licensing requirements, and failure to guarantee the total amount of the annuity. Protections at 4, 24-29.



If the intent of Congress was to exclude all insurance products from ERISA's reach, Congress would easily have done so. But it did not. Instead, Congress sought to protect participants and beneficiaries, even those whose retirement funds are invested in insurance products, so that their retirement funds would be secure. Toward this end, Congress designed ERISA to require the persons handling the investments that support such benefits to adhere to fiduciary standards so that plans will be properly and adequately funded. Consequently, consistent with the purposes of ERISA to protect participants and beneficiaries, the nonguaranteed "free funds" portion of the group annuity contract should be subject to ERISA's fiduciary rules.

## CONCLUSION

For the foregoing reasons, AARP, Legal Services for the Elderly, and NELA respectfully ask the Court to affirm the decision of the Court of Appeals below.

Respectfully submitted,

Edgar Pauk
Legal Services for
the Elderly
130 West 42nd Street
Suite 1700
New York, NY 10036
(212) 319 0120
Counsel for *Amici*
Legal Services for
the Elderly

Jeffrey Lewis
Sigman & Lewis
405 Fourteenth Street, #1100
Oakland, CA 94612
(510) 839-6824
Counsel for *Amici*
National Employment
Lawyers Association

Cathy Ventrell-Monsees
Joan S. Wise
Mary Ellen Signorille
(Counsel of Record)
American Association
of Retired Persons
601 E Street, N.W.
Washington, DC 20049
(202) 434-2060
Counsel for *Amici*
American Association
of Retired Persons

July 1993

# APPENDIX

March 19, 1985

Office of Regulations and Interpretation
Office of Pension and Welfare Benefit Programs
Room C-4526
U.S. Department of Labor
Washington, D.C. 20210
Attn: Proposed Plan Assets Regulations

RE: Department of Labor Proposed Regulation Relating to the Definition of Plan Assets, as published at 50 Fed. Reg. 961 (January 8, 1985).

Dear Sir:

The following comments on the Proposed Regulation noted above are offered on behalf of the American Council of Life Insurance ("ACLI" or "Council"). The ACLI is a trade association representing 615 life insurance companies which, in the aggregate, account for approximately 95% of the life insurance in force in the United States, and hold 97% of the assets of insured pension business.

As discussed in detail below, we believe the Proposed Regulation needs to be revised in several important respects. Because of the importance of these issues to our business we request an opportunity to expand on our remarks at the public

hearings to be held on May 6 and (if necessary) May 7, 1985. Our detailed comments on the Proposed Regulation are set forth below.

1. APPLICATION OF PROPOSED REGULATION TO LIFE INSURANCE COMPANY GENERAL ACCOUNT ASSETS

In contrast to the earlier efforts of the Department of Labor ("the Department"), the newly Proposed plan asset Regulation and the accompanying release does not explicitly address the statutory exemption provided under ERISA Section 401(b)(2) for the underlying assets held in a life insurance company's general account. As the Council has indicated in prior submissions to the Department on this subject, uncertainty concerning the status of general account assets for purposes of ERISA materially and adversely affects the insurance industry's management and investment of billions of dollars of assets and the anticipated operation of hundreds of thousands of contracts to the detriment of the industry, its policyholders (which include employee benefit plans and participants), shareholders and third parties that look to insurance company general accounts as a



source of investment or operating funds for their businesses.1/ Therefore, the Council urges the Department to modify the Proposed plan asset Regulation to explicitly provide that general account assets are not "plan assets".

Discussion

Since ERISA's enactment, the life insurance industry has conducted its business on the basis of a common understanding that its general account assets are not "plan assets" under ERISA and that, consequently, it is not subject to ERISA's fiduciary responsibility and prohibited transaction provisions in managing such assets.

As discussed below, there have been two primary sources of support for this understanding:

(1) Section 401(b)(2) of ERISA and the legislative history thereof; and

(2) Consistent Department of Labor administrative inter-pretations.

1/ For a description of these problems, see pages 4-7 and 28-32 of the letter dated March 21, 1984 filed with the Department by the Council.

Section 401(b)(2) and Legislative History.

Section 401(b)(2) of ERISA provides that –

> in the case of a plan to which a guaranteed benefit policy is issued by an insurer, the assets of such plan shall be deemed to include such policy, but shall not, solely by reason of the issuance of such policy, be deemed to include any assets of the insurer.

As the Council has detailed in previous submissions to the Department, the legislative history underlying this provision reflects a clear intent by Congress to exclude from "plan asset" treatment funds held by a life insurance company, other than in a separate account. Furthermore, Congress would have specifically provided that general account assets are to be treated as "plan assets", had it intended to regulate the operating accounts of insurance companies.2/

2/ See pages 16-23 of the letter dated March 21, 1984 filed with the Department of Labor by the Council. The Department has previously recognized that congress did not intend to treat general account assets as "plan assets". Oversight on ERISA: Testimony of Paul J. Fasser, Jr., Assistant Secretary of Labor, hearings on (continued...)



Consistent Administrative Interpretations

The industry's understanding that general account assets are not "plan assets" has been supported by the Department's general interpretation of ERISA as it applies to the assets of an operating business in which an employee benefit plan might have an interest. Shortly after ERISA's enactment, representatives of the life insurance industry requested that the Department and the IRS issue interpretive rulings to resolve any ambiguity in Section 401(b)(2). This interpretive request included descriptions of various types of pension contracts (e.g., deferred annuity contracts, deposit administration contracts and immediate participation guarantee contracts) under which contractholder payments are allocated to an insurer's general account.

In response, and as one of their first major pronouncements under ERISA, the Labor Department and the IRS promulgated IB 75-2 (February 6, 1975) and Technical

2/(...continued)
Public Law 93-460 before the Subcommittee on Labor Standards of the House Committee on Education and Labor, 94th Cong., 1st Sess. 390-91 (1975).

Information Release 1346 (February 6, 1975) ("TIR 1346"). In particular, IB 75-2 provides that –

> if an insurance company issues a contract or policy of insurance to a plan and places the consideration for such contract or policy in this general asset account, the assets in such account shall not be considered to be plan assets.

IB 75-2 and TIR 1346 did not purport to amplify the meaning of "guaranteed benefit policy." Rather, they discuss an employee benefit plan's interest in a contract, the consideration for which is placed in an insurer's general account, as one example of the circumstances under which the underlying assets of an operating business do not by virtue of such interest become "plan assets". The Department has subsequently reiterated the interpretation set forth in IB 75-2 on a number of occasions, including its earlier, proposed version of the "plan asset" regulations.3/

---

3/ See 44 Fed. Reg. 50363, 50364 n.4 (Aug. 28, 1979). Prohibited Transaction Exemption 79-41, 44 Fed. Reg. 46365, 46368 (Aug. 7, 1979); 46 Fed. Reg. 46443, 46444 (Sept. 18, 1981).



Therefore, the Department of Labor has consistently and explicitly taken the position that when an insurance company issues a contract to fund an employee benefit plan, and considerations paid under the contract are placed in the insurance company's general account, the general account assets do not as a result become "plan assets" for purposes of ERISA. Such position is entirely consistent with the legislative history of ERISA, the policy underlying that statute and the Department's general approach in seeking to define what are "plan assets." In the ten years since ERISA's enactment, neither the Department nor the IRS has taken any enforcement or other action inconsistent with this interpretation.

The Need for Explicit Regulatory Relief for General Account Contracts.

The industry's reliance on the common understanding of what constitutes plan assets has recently been called into question by the decision of the Seventh Circuit Court of Appeals in Peoria Union Stockyards Company Retirement Plan v. The Penn Mutual Life Insurance Company, 698 F.2d. 320 (7th Cir. 1983).

That case held that a general account deposit administration group annuity contract was not a "guaranteed benefit policy" within the meaning of Section 401(b)(2). It is important to note that the Depart-ment's general interpretation of the term "plan assets" and its particular application of that interpretation to general account assets was not brought to the attention of the Court in Peoria, and the Court's analysis of the defendant insurer's status as a fiduciary did not go beyond an interpretation of the language of the Section 401(b)(2) exclusion. If no other authority addresses the issue of what constitutes "plan assets", it is possible that the Peoria Court's analysis of the Section 401(b)(2) exclusion could be followed and funds held by an insurer in its general account construed to be "plan assets".

For the reasons set forth in the Council's letter to the Department dated March 21, 1984, the Council believes that the holding in Peoria is inconsistent with both the legislative history and legislative policy underlying Section 401(b)(2) -- namely, that contracts issued by an insurance company's general account do not cause the underlying general account assets to be regarded



as "plan assets" -- and that Peoria's general application would materially and adversely affect the life insurance industry's investment and management of its general account in a fashion clearly not intended by Congress. Further, we believe that the Peoria Court's holding resulted largely from the ambiguity of the term "guaranteed benefit policy," and that ultimately legislation is essential to definitively correct the problem.

Pending such legislative clarification of Section 401(b)(2), it becomes particularly important for the Department to explicitly and unambiguously reaffirm its position that the general account assets of an insurer should not be regarded as "plan assets." The rationale is similar to that which supports the conclusion that the assets of other business corporations in which a plan may invest or with which a plan may contract are not "plan assets."

Insurance Companies Should be Treated Consistently With Operating Companies

While the Department has refined its general approach to defining "plan assets" since the release of IB 75-2, the basic

principles underlying that general approach have not changed and continue to support the position that general account assets are not "plan assets". Under the current Proposed plan asset Regula-tion, the Department continues to take the position that the significance and nature of the interests of employee benefit plans in the profits and investment results of an entity are not necessarily determinative of the status of the entity's assets as "plan assets" for purposes of ERISA.

Thus, the Proposed plan asset Regulation specifically excludes from "plan asset" treatment the assets of operating companies (including but not limited to, venture capital and real estate operating companies) without reference to the nature or significance of employee benefit plan participation in the profits or losses derived from those companies' assets. The rationale underlying the exclusion of the assets of such companies from "plan asset" treatment is that it is neither practical nor appropriate to require an operating company to manage its assets solely in the interests of and for the exclusive purpose of providing benefits to employee benefit plans which invest in or



contract with the company. The fact that some obligations under particular general account contracts are related to or affected by the return derived from general account investments does not affect the characterization of a general account as an operating business and the conclusion that general account assets are not "plan assets".

The same premise -- that it is neither practical nor appropriate to require an operating business to manage its assets solely in the interest of and for the exclusive purpose of providing benefits to employee benefit plans which invest therein -- is equally applicable to the general account of a life insurance company.

As the Council has demonstrated in previous submissions to the Department, a life insurance company general account is most properly characterized as the assets and liabilities of an operating business which primarily involves the assumption and management of risks and other obligations in return for consideration. While the investment of capital is a significant function in connection with the management of the insurance

business, it is neither an autonomous function nor a life insurance company's primary function. Rather, the investment of its general account funds is one of many functions which a life insurance company undertakes in supporting and managing its obligations to its life insurance, health insurance and annuity contractholders as well as other parties with whom the company has a business relationship.

Recommendation

The Department should provide clear-cut relief from plan asset status for the general accounts of insurance companies, as this is what was intended by the Congress in enacting the Section 401(b)(2) exemption for "guaranteed benefit policies." Because of Peoria, we believe it is imperative that this issue be addressed explicitly in the final regulation.

The Department thought it important to provide express "plan asset" relief to registered investment companies, venture capital operating companies and real estate operating companies.



In our view it is as important to grant explicit regulatory relief to life insurance company general account assets.4/

Therefore, the Council specifically recommends that the Proposed plan asset Regulation be modified by amending paragraph 2510.3-101(a)(2) to read as follows:

> (2) Generally, when a plan invests in another entity, its assets include its investment, but do not, solely by reason of such investment, include any of underlying assets of the entity. However, when a plan acquires an equity interest in an entity that is (nei-ther) not a publicly-offered security, (nor) not a security issued by an investment company registered under the Investment Company Act of 1940 nor an interest arising out of a contract issued by an insurance company licensed to do business in a state, other than an interest subject to paragraph (f), its assets include both the equity interest and an undivided

---

4/ If the Department, contrary to the Council's request, decides not to explicitly provide that general account assets are not "plan assets," the Council strongly urges the Department to make clear that until this issue is dealt with in regulations, IB 75-2 remains in effect insofar as it applies to the status of general account assets. To do otherwise will create a regulatory vacuum on this issue which would exacerbate the uncertainty concerning the status of general account assets to the material detriment of the insurance industry, its policyholders (including employee benefit plans and participants), shareholders and third parties that look to insurance company general accounts as a source of funds for their businesses.

interest in each of the underlying assets of the entity, unless it is established that –

The Council believes this recommendation is consistent with the general principles underlying the Proposed Regulation and protective of the interests of employee benefit plans as it covers only the status of insurance company entities.

2. THE EFFECTIVE DATE AND TRANSITIONAL RULES IN PREAMBLE SECTION (H) AND REGULATION SECTIONS 2510.3-101(i)

If adopted, the Proposed Regulation would be effective for purposes of identifying "plan assets" at any time on or after ninety days from the date of publication as a final regulation. In addition, the proposal (as amended by the Department on February 15, 1985) provides a transitional rule that the regulation would not apply to plan investments in an entity that is in existence on June 30, 1986, if no employee benefit plan subject to Title I of ERISA or non-excluded plan described in Section 4975(e)(1) of the Internal Revenue Code of 1954 acquires an interest in the entity from an issuer or an underwriter at any time after June 30, 1986, except pursuant to a binding contract in effect on that date.



We are pleased that the Department has amended the Proposed Regulation to address the potential retroactivity problem present under prior Proposed Regulation Section 2510.3-101(i). We suggest, further, that if final regulations are not published 90 days prior to the June 30, 1986 date now specified in the Proposed Regulation, that this date be extended until 90 days after final regulations are in fact published. Prior to that point, IB 75-2 should be continued (see footnote four on page 10). In this way investment managers will only be subject to two consecutive standards and the situation where investment decisions must be made without knowledge of the applicable legal guidelines will never arise.

3. STATUS OF SEPARATE ACCOUNTS

Proposed Regulation Section 2510.3-101(f) sets forth certain situations under which interests acquired by a plan in a separate account do not constitute "plan assets". We believe that a provision should be added to this section to provide that if a separate account would qualify as: (1) a venture capital operating company; (2) a real estate operating company; or (3) otherwise

qualify for exclusion from "plan asset" status, then the underlying assets of the separate account do not constitute "plan assets".

As noted in the prior discussion of insurance company general accounts, the Proposed Regulation explicitly excludes from plan asset treatment the assets of venture capital or real estate operating companies without reference to the nature or significance of employee benefit plan participation in the profits or losses derived from those companies' assets. If an insurance company's separate account qualifies in all other respects as either a venture capital operating company or a real estate operating company, equity argues that the insurance company separate account should be treated in the same fashion as those operating companies.

We believe, further, that it would be helpful to add an example to the Proposed Regulation to illustrate one circumstance under which pooled separate account assets would not be "plan assets". Such an example follows:

> S is a pooled separate account maintained by I, an insurance company. There is



> significant participation in S by plan investors, including more than one employee benefit plan investor. More than 85 percent of the fair market value of the assets of S consist of real estate investments with respect to which S has the right to participate in, or influence, the management of the real estate. Although S has no employees, all such rights are in fact exercised by I acting on behalf of S. Under these facts, S is a "real estate operating company".

4. <u>EXAMPLES UNDER SECTION 2510.3-101(h)</u>

Example 13 under Section 2510.3-101(h) is both ambiguous and, in our view, incomplete. This example is designed to illustrate what is meant by the term "real estate operating company". It states:

> X maintains a staff of employees who preform (sic) management and development services, but X also retains independent contractors to perform some tasks. Under these facts, X is a real estate operating company.

As currently stated, this example may be misconstrued to mean that in order for an entity to be treated as an operating company its own employees must perform the management and development services. Typically, properties are managed and

developed through partnerships or corporations which are responsible for management and development but utilize employees of a general partner or its affiliates or retain independent contractors to perform those functions. However, as the partnership or corporation is responsible for those functions, it is no less a "real estate operating company" than if it hired employees to perform those services. In many cases, it is less costly to perform those services through a general partner or independent contractor than through employees of the entity owning the property.

Therefore, we strongly urge the Department to add an additional example to read as follows:

> X is a partnership in which there is significant equity participation by employee benefit plans. More than 85 percent of the fair market value of the assets of X consists of commercial real estate properties which X has acquired. X, which does not have its own employees, has retained I, an independent contractor, to perform property management functions on behalf of X with respect to X's properties. X retains significant rights with respect to X's properties including the approval of the acquisition or sale of properties, the approval of leasing guidelines and of substantial leases of space in the properties, and the approval of capital expenditures and other significant expenditures with respect to the properties. Under these facts, X is a real estate operating company.



In addition, as currently drafted, the statement in Example 13 of the percentage of assets that must be devoted to management and development activities is ambiguous. Under the example, more than 85% of the fair market value of the entity's assets must be devoted to management and development activities. We assume that the intent of the drafters was to require the entity to manage or develop a stated percentage of assets, not to require that a certain percentage of the entity's assets be devoted to management and development. We therefore, suggest that this language be redrafted as follows:

> On its most recent valuation, X managed or developed assets comprising more than 85% of the fair market value of its assets.

A comparable change should be made to Proposed Regulation Section 2510.3-101(c)(3).

5. NEED FOR CLEAR GUIDANCE ON DIFFERENCE BETWEEN EQUITY AND DEBT INTEREST

Under Section 2510.3-101(a) of the Proposed Regulation, if a plan acquires a significant "equity interest" in an entity (other than a security issued by a registered investment company, a publicly-offered security or an interest in an operating company), the assets of the plan will include an undivided interest in the assets of the entity in which the plan invests. On the other hand, if a plan acquires a debt instrument, the underlying assets of the entity issuing the debt instrument will not be deemed to be plan assets.

Because the distinction between debt and equity can determine whether the underlying assets of an entity are deemed to be plan assets, the definition of an "equity interest" is of critical importance to plans and the entities in which they invest. The definition contained in the Proposed Regulation does not, however, provide a clear guideline for determining whether an interest is debt or equity, particularly in the context of certain types of real estate investments. Without such guidance, the "plan assets" status of many investments under ERISA will be



unclear and the managers of such investments will be uncertain as to whether and to what extent they must comply with ERISA. Accordingly, because plans, especially plans investing in real estate, need clear guidance as to the "plan assets" treatment of investments, we urge that the proposed Regulation be modified to provide a clear safe harbor from "equity interest" treatment.

We understand that the law firm of Groom and Nordberg is filing detailed comments on this issue on behalf of several individual companies. The ACLI endorses those comments and refers the Department to them for a more thorough discussion of this issue.

6. STATUS OF EMPLOYEE CONTRIBUTIONS

The preamble to the Proposed Regulation states that:

> The Department is separately considering what action to take with respect to the portion of the 1979 proposal that relates to employee contributions.

We assume that the Department plans to take further action with regard to rules on employee contributions and does not anticipate receiving comments on such contributions in connection with the Proposed Regulation. The ACLI does wish, however, to advise

the Department that our position with regard to the status of employee contributions remains as stated in our memorandum on this topic dated November 16, 1979.